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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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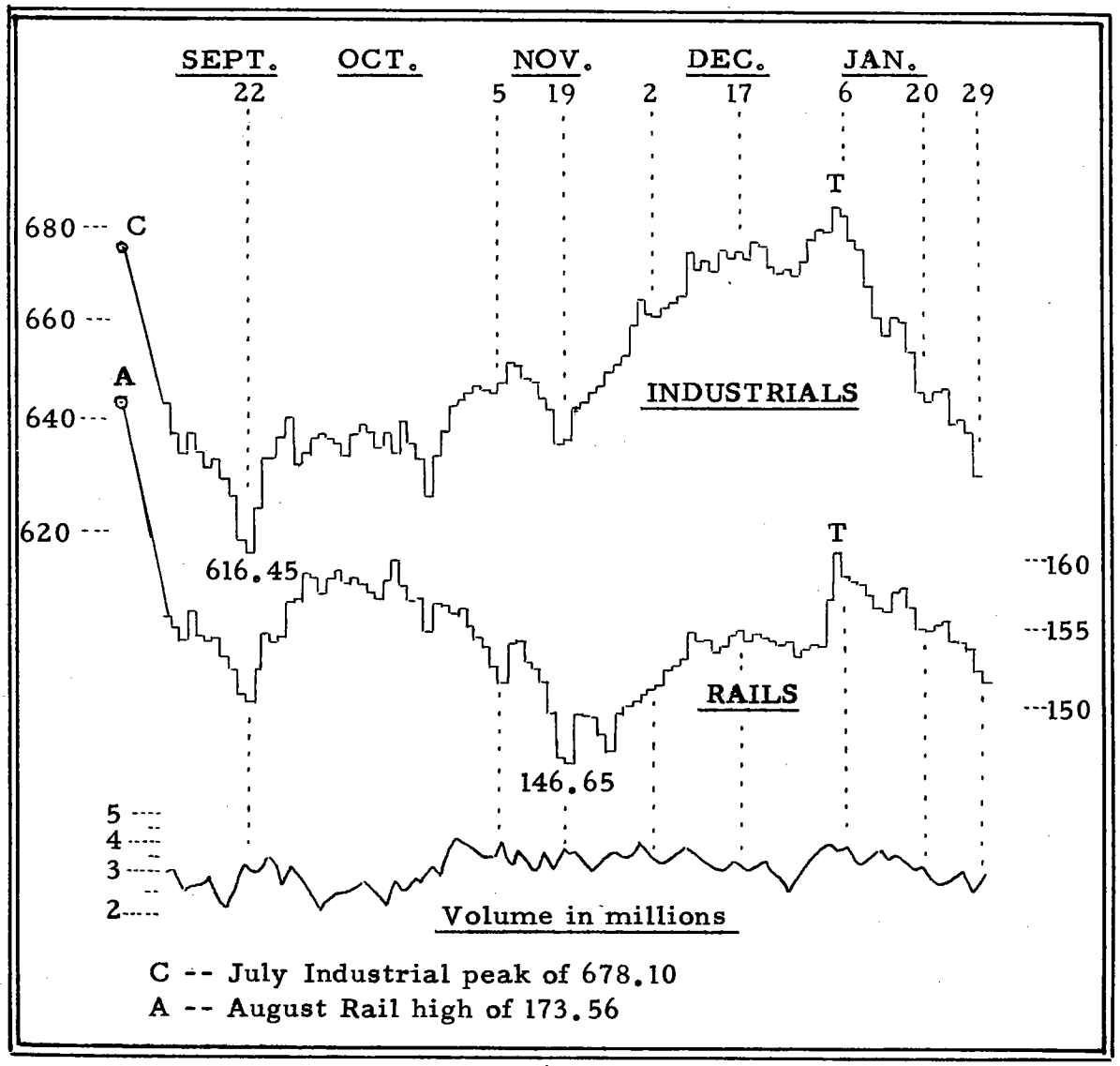
PRICE MOVEMENTS. In the eighteen trading days since January 5 (T - see chart), prices have dropped in all but four sessions. As of this writing, Industrials have lost 63 points while Rails have given back 8. It is noteworthy that odd-lot (under-100-share) transactions on the entire decline have shown a rate of buying equal to four shares purchased for every three sold. This is a fairly high rate of buying, and it suggests that the public (as exemplified by odd-lot transactions) has remained bullish. Evidently the odd-lotter is unshaken in his belief that prices are bargains as they work lower. Odd-lot short-sales have held quite low, and considering the drastic drop, this too is an unfavorable sign. Generally the odd-lot short seller will turn bearish with sharply lower prices, but the present odd-lot short figures suggest that the public does not view short selling as a potential source of profit at this time.



Much is being written about the relatively low volume on the decline, and many analysts are suggesting that this is a bullish sign. But on the last decline prior to the bear signal in 1937 and again in 1946 volume held to one million shares per day or less throughout the whole move. As stated on page 1 in Letter 91, volume can be deceptive. If a bear signal is to be given, there are excellent precedents for consistently low volume on the final decline before a bear signal. It is possible that heavy volume will not make its appearance until the actual day of the bear signal.

I want to stress again that the indications of a single Average (unconfirmed by the other) are meaningless for prediction purposes. Should Industrials violate their reaction low (616.45) and the rails persistently hold above their low low (146.65), the penetration could prove to be false. Conversely, a Rail penetration without an Industrial confirmation could be equally deceptive.

APPRAISAL. For six months the Averages have been fluctuating between the highs (Industrials 685.67, Rails 173.56) and the 1959 reaction lows (Industrials 616.45, Rails 146.65). This area is called "secondary territory", and back in October, 1959 (Letter 81) I described the problems which may be met in such areas as follows: "Price movements within secondary areas are generally more deceptive and difficult to interpret than any others encountered by market students. This is particularly true in secondaries which occur during the third (erratic) phase of a bull market. There have been occasions in the past when the two Averages traveled within secondary territory for months on end before providing a clear bull or bear signal -- a situation which can play havoc with the nerves of the most hardened investors."

If it turns out that the bull market ended in July, 1959 (see chart), then the July-September sell-off was the first leg of a primary bear market. The subsequent advance which took both Averages to T would be the first reaction (upward) in a bear market, and the decline since T would have to be reclassified as the second leg of a bear market. Of course we will not know whether any of this is true unless (or until) both Averages crack their reaction lows on accompanying high volume.

The Dow Theory states that a bull (or bear) trend continues until proved otherwise. The primary trend was confirmed as bullish in 1950, and that signal has not yet been retracted. In the last Letter, I noted that some long-term investors are continuing to retain stock on the basis of this "continuing trend" principle; they will not sell on anything this side of a primary bear signal.

THE "PROJECTERS" Over the last few years a veritable army of neophyte analysts has swept into Wall Street. Day after day, new reports on individual securities and even whole industries are written and distributed. In the great majority of cases, these reports deal with optimistic projections (with accompanying trendlines) of present and past corporate performances. Analyzing what has happened -- and then drawing conclusions about what should happen -- may work well enough in the early and even middle stages of an extended bull market. But seasoned investors are aware that in the latter stages of the cycle the projecting method has a habit of "backfiring." The latest example of backfiring which I can remember concerns the "booming" airline industry. Back in March, 1959, when the airline stocks were forming their tops, I received dozens of letters from readers stating that if we only had a few airline stocks mixed in with the Rail Average, that Average would have some validity as an indicator of transportation. The airlines, I was told, were about to put the Rails out of business. Yet judging by the subsequent collapse in airline equities, one wonders if the airlines are not about to put themselves out of business.

The fatal error made by those who play the "projecting game" is in assuming that a tree can grow to the sky. There are big trees and little trees, but as any botanist can

tell you, no tree has ever parted the clouds. Charles H. Dow put it another way back in 1902: "The one thing pertaining to all conditions is that they will change." He knew that you can project everything except the most important thing of all -- human psychology. And without taking the human equation into consideration, forecasts based on upward slanting trendlines can go grotesquely wrong.

Personally, I must confess that when I put away the latest book on economics, it is usually with mixed feelings of skepticism and annoyance. For the economic studies which come my way invariably deal with problems after they have occurred. In the majority of cases, investors would go "broke" if they were to wait for the explanation of a downturn in the stock market. All of which brings me to the study of the Averages. For only the Averages make allowances for the psychology, the knowledge, fear and hopes of everybody. This "allowance" is the ability of the Averages to discount, and it is our only clue to the future.

1950. Last week I spent some time browsing through copies of Barron's published in early 1950. A few things struck me as being significant. One was the absence of anything resembling the recent spate of "Fabulous Sixties" predictions. Forecasts back in January, 1950, were rather somber and conservative, which is interesting in view of the great 10 year boom which followed. This also points up the thesis that a prerequisite for a boom or a bust is a universal disbelief in the possibility of either's occurring. Obviously, if everybody in 1950 thought a boom was on the way, they would all have jumped into the market simultaneously, and the boom would have arrived and departed in the twinkling of an eye.

The other thing which interested me was the number of stock market services which were operating then, but which have since passed by the wayside. This high mortality rate, I believe, is a direct result of the average service's insistence on "forecasting" things which, unfortunately, never materialize. A large number of organizations in 1950 were attempting to attract readers through advertisements concerning the impending "post-war collapse". The collapse never came. Had the owners of these market letters held their preconceived notions in check and taken time out to study the implications of the Averages, they might well have remained in business to this day. All too often the services are intent on playing "expert", but the market insists on going its own way. The result is that the services turn out exciting literature while their subscribers are left without the price of a renewal.

QUESTION. What could cause a bear market to start here?

ANSWER. The reasons for a bear market are rarely known in advance and seldom even afterwards. It is not within the scope of these Letters to examine the fundamental conditions of the economy, and from a Dow Theory standpoint, such study generally is unnecessary.

QUESTION. Should I put out shorts here?

ANSWER. If there is to be a bear market, the value of cash will increase as the economy turns down. If the investor can merely keep his funds intact through a bear market, he will be far ahead of the game. However, some traders prefer speculating for the decline. Personally, and after long experience, I do not believe that the average investor does well with shorts. Many of the same people who are able to show handsome profits on the bull side do not have the temperament to make money

on the short side. In general, the place to put out shorts is on rallies (reactions upward) that grow dull, following a confirmed bear signal. I warn readers against shorting against the primary trend, and the primary trend cannot be considered down until a bear signal is given.

QUESTION. Should I hold bank stocks, bonds or preferred stock if a bear signal is given?

ANSWER. In a bear market the prime consideration is capital protection, and this means only one thing -- investing in short-term Treasury bills. Should a money crisis develop in the next bear market (and I believe there is that possibility), preferred stocks and bonds will go through the wringer along with common stocks.

NOTE: I wish to thank the many hundreds of subscribers who sent in their extensions. I have had to make a choice between answering some portion of the correspondence recently received or giving my attention to the market. In fairness to subscribers, I chose the latter. Where possible, I will attempt to answer some of the questions in the near future. Over the last three weeks the circulation of these Letters has increased about 20%, and this alone has prevented me from doing all the question-answering which I normally do. Again, I must ask those who wrote in recently to forgive me. I might add, however, that I have read each letter which arrived here with interest.

(Written February 1, 2 P.M.)